

# Economic Outlook



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The economic statistics continue to paint a mixed picture of economic strength. Employment growth has slowed down after a strong showing early in the summer, while business orders and sales have remained relatively healthy. The trade statistics suggest a moderation in the robust pace of export growth and hint that import growth may be picking up again. Unemployment remains quite low and initial claims for unemployment insurance are still around the lowest levels of the past 15 years. The Commerce Department has announced that drought effects will reduce GNP growth by .5% in the third quarter and 1.5% in the fourth quarter, after trimming second quarter growth by almost a full percentage point. All tolled, the drought will take a substantial three-fourths percentage point off 1988 growth. Nevertheless, output continues to grow at a robust pace.

The government is easing planting restrictions next year to help farmers rebuild low grain inventories. If the weather cooperates, next year should see a hefty addition to output growth from the farm sector. As a result, our forecast now reflects the slowdown effects of the drought through year-end and a significant pickup next year from an unusually strong planting season. Rather than the smooth deceleration of our earlier outlook, we now expect a somewhat greater initial slowdown with a pickup in early 1989 before the economy moves onto the slower growth track that the Federal Reserve desires to avoid any further worsening in inflation. The year-end drought effects suggest that the Fed and the markets may be lulled into thinking that the Fed's tightening to date is doing the job.

|      | Real Final Sales* | Real GNP |
|------|-------------------|----------|
| 1986 | 2.7               | 2.0      |
| 1987 | 3.4               | 5.0      |
| 1988 | 5.7               | 3.1      |

\* QIV-QIV percent changes, except 1988 first half growth.

But real final sales remain too high for output growth to stay below 3% on a sustained basis (See table). The pickup in first-half 1989 output is likely to rekindle Fed and market concern about inflation and the unsustainable pace of economic growth. Consequently, the outlook assumes monetary policy will remain in a firming posture. Because sales increases have exceeded production growth, inventories show no signs of overbuilding at this stage of the expansion. Strong third quarter inventory accumulation has been matched by healthy business sales so that the inventory sales ratio remains unchanged at 1.50. Since excess inventories are one warning sign of impending recession, these statistics suggest little likelihood of a recession anytime soon. In fact, car inventories entered the new model year in the best shape in recent years, prompting larger-than-usual price increases in the new models.

The September employment report presented a mixed picture of the economy. Payroll employment increased by a respectable 255,000 jobs. A large part of the increase, however, was due to an unusually big seasonal pickup in new

teachers jobs. In addition, the growth in August employment was revised down substantially. Employment in the manufacturing sector decreased for the second month in a row, leading some observers to herald the end of the two-year old industrial recovery. Nevertheless, the length of the factory workweek and overtime bounced back in September and stand at high levels normally associated with robust production. Strong factory orders also suggest that reports of the industrial expansion's demise are greatly exaggerated. Continued signs of growing capital spending support this view. Overall, the index of aggregate weekly hours for the third quarter suggests economic growth well above 3%. Furthermore, the unemployment rate dropped back down to 5.4% and wage growth picked up to higher earlier levels, suggesting a continued risk of overheating in the labor market. It is difficult to see how wage growth will fall off in an environment where job growth continues to exceed the growth in the labor force.

One danger in the latest numbers is the relative shift toward stronger domestic demand compared with foreign demand for U.S. output. The dollar has weakened as the markets have sensed this shift. Given a choice between domestic and foreign demand, the Fed would obviously prefer to see the latter grow faster to improve the U.S. balance of payments. A slowdown in U.S. growth due to a stall-ing trade improvement and drought-induced output losses is more inflationary than a slowdown from declining domestic demand. Until domestic demand growth moderates significantly, the economy will continue to have an inflationary bias.

Robert T. McGee

#### Real GNP

(Percent Contribution to  
Real GNP Growth; Annual Rates)

|                        | Actual |      |      |      | Forecast |      |      |      | Actual        |  | Forecast    |      |  |
|------------------------|--------|------|------|------|----------|------|------|------|---------------|--|-------------|------|--|
|                        | 1987   |      | 1988 |      | 1988     |      | 1989 |      | 1986-<br>1987 |  | 1987- 1988- |      |  |
|                        | III    | IV   | I    | II   | III      | IV   | I    | II   | 1987          |  | 1988        | 1989 |  |
| Consumer Spending      | 3.0    | -1.4 | 2.9  | 1.9  | 1.6      | 1.3  | 1.3  | 1.1  | 1.8           |  | 1.7         | 1.2  |  |
| Business Investment    | 3.0    | 0.2  | 0.9  | 1.7  | 1.3      | 1.1  | 1.1  | 1.0  | 0.3           |  | 1.3         | 1.1  |  |
| Residential Investment | -0.6   | 0.0  | -0.3 | 0.0  | -0.1     | -0.2 | -0.2 | -0.2 | 0.0           |  | -0.2        | -0.2 |  |
| Change in Inventories* | -1.0   | 6.3  | -2.0 | -2.8 | 0.1      | -0.3 | 0.3  | 1.0  | 0.2           |  | -0.1        | 0.2  |  |
| Net Exports            | -0.5   | 0.5  | 1.7  | 1.7  | 0.3      | 0.3  | 0.3  | 0.2  | 0.2           |  | 0.9         | 0.4  |  |
| Government Purchase*   | 0.6    | 0.5  | 0.2  | 0.5  | 0.3      | 0.3  | 0.3  | 0.3  | 0.9           |  | 0.4         | 0.3  |  |
| Real GNP               | 4.5    | 6.1  | 3.4  | 3.0  | 3.5      | 2.5  | 3.1  | 3.4  | 3.4           |  | 4.0         | 3.0  |  |

#### Quarterly Economic Indicators

(Percent Changes  
at Annual Rates)

|                              | Actual |     |      |      | Forecast |     |      |     | Actual        |  | Forecast    |      |  |
|------------------------------|--------|-----|------|------|----------|-----|------|-----|---------------|--|-------------|------|--|
|                              | 1987   |     | 1988 |      | 1988     |     | 1989 |     | 1986-<br>1987 |  | 1987- 1988- |      |  |
|                              | III    | IV  | I    | II   | III      | IV  | I    | II  | 1987          |  | 1988        | 1989 |  |
| Nominal GNP                  | 7.7    | 8.6 | 5.4  | 8.7  | 8.1      | 7.6 | 8.7  | 9.5 | 6.8           |  | 7.5         | 8.7  |  |
| GNP Deflator                 | 3.1    | 2.4 | 1.7  | 5.5  | 4.6      | 5.0 | 5.4  | 5.9 | 3.3           |  | 3.4         | 5.5  |  |
| Corporate Profits After Tax# | 12.7   | 5.7 | 10.3 | 18.1 | 9.6      | 8.9 | 7.5  | 5.8 | 10.2          |  | 11.7        | 6.4  |  |

#### Monthly Economic Indicators

|                                          | Recent Data |        |       | Actual |  | Forecast |        |  |
|------------------------------------------|-------------|--------|-------|--------|--|----------|--------|--|
|                                          | July        | Aug.   | Sept. | 1987   |  | 1988     | 1989   |  |
| Consumer Price Index** (%)               | 0.4         | 0.4    | n.a.  | 4.4    |  | 4.8      | 6.3    |  |
| Industrial Production (%)                | 1.2         | 0.2    | 0.0   | 3.7    |  | 5.5      | 3.0    |  |
| Retail Sales (%)                         | 0.5         | -0.1   | -0.4  | 5.1    |  | 5.7      | 5.2    |  |
| Auto Sales (million units, a.r.)         | 10.7        | 10.6   | 10.6  | 10.3   |  | 10.7     | 9.8    |  |
| Housing Starts (million units, a.r.)     | 1.49        | 1.44   | n.a.  | 1.63   |  | 1.45     | 1.35   |  |
| Unemployment Rate (%)                    | 5.4         | 5.6    | 5.4   | 6.2    |  | 5.5      | 5.2    |  |
| Merchandise Trade Balance (\$ bn., a.r.) | -114.0      | -146.4 | n.a.  | -171.2 |  | -145.0   | -125.0 |  |

\*Adjusted for CCC purchases.

\*\*Annual percent changes are December to December.

#Quarterly data are year-over-year percent changes.

a.r. = annual rate

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